The Kiplinger Letter

FORECASTS FOR EXECUTIVES AND INVESTORS

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Dear Client: Washington, July 29, 2016

Though U.S. manufacturing is in a funk now... The longer-term outlook is fairly positive. That's welcome news after job losses in the recession led to China displacing America as the global leader in manufacturing and left many plants in mothballs.

ECONOMY

Production capacity in the U.S. will grow... More than in other nations...over five years. That is sure to add to the 800,000 manufacturing jobs and 62% jump in foreign direct investment in the U.S. that have been logged since the recovery took root.

Big names leading the way: General Electric, Ford, General Motors, Whirlpool, Toyota and more.

Some firms that left the U.S. will return, reversing a years-long pattern of moving overseas to take advantage of lower labor costs and taxes. One example of a "reshoring" firm: Brooks Brothers.

Behind the reversal: Higher costs in China. Wages, power rates and political uncertainty are up. Electricity prices are at least 34% lower in the U.S. than in China...and about 50% lower than in Europe... thanks to the recent boom in natural gas production.

A growing demand for "Made in America" products, fueling opposition to major trade agreements between the U.S. and countries in Europe and Asia.

A global view that the U.S. offers a stable political climate in general, despite how it might look as Donald Trump and Hillary Clinton battle in the election.

And stronger intellectual property protections than are found elsewhere.

Much of the expansion will be in the Southeast: N.C., S.C., Tenn. and Ga., all right-to-work states with friendly business climates that appeal to growing firms.

Plus Ohio and Mich., two Rust Belt states that were hit hard by the slump. They offer plenty of factory space and a huge group of workers eager for bigger checks.

Among companies that will benefit: Makers of appliances, furniture, cars and other big items that cost a lot to ship and are helped by proximity to U.S. buyers.

And tech-heavy firms that use 3-D printing, robotics and digital processes, which take advantage of infrastructure, research programs and access to capital.

Still, U.S. manufacturing won't return to its mid-20th-century halcyon days.

For the short term, the strong dollar is one key limiter of industrial growth, cutting into potential foreign markets by making American exports too expensive.

Longer term, automation will help to magnify the lack of skilled labor, since most jobs in automated shops require more-advanced training than other jobs. Some states are turning to apprenticeship programs to try to close the skills gap.

But overall, there's more good news than bad in industrialized America as the country reclaims and refurbishes its once-proud reputation for making things.

ECONOMIC FORECASTS

GDP growth NEW
Moderately higher in second-half '16; 1.4% for '16, 2% for '17

Interest rates
10-year T-notes dipping to 1.4% at end '16; 1.6% at end '17

Inflation
1.8% at end '16; 2.4% at end '17

Unemployment
Ending '17 at 4.5%, from 4.9% now

Crude oil
Trading from $40 to $45/bbl. in Sept.

Business spending
Flat in '16 on slowing global growth, high dollar, soft energy spending

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MORE ECONOMY The second-quarter GDP report raises fresh concerns about the U.S. economy. A hoped-for bounce in growth didn't materialize because of lower investment by businesses. Robust consumer spending helped offset that and push growth to 1.2%. But a number of risks...a stronger dollar, the impacts of a volatile presidential race... still loom, and could further dampen investment or make shoppers more cautious.

For the full year, expect growth of about 1.4%...a lackluster showing at best.

BUSINESS SPENDING U.S. businesses are tapping the brakes on investing in new equipment. The dollar's renewed strengthening in the aftermath of the Brexit surprise presents a fresh headwind for exporters, and weaker oil prices are weighing on sales of drilling gear and related equipment. Plus a buildup of unsold goods in inventory is holding many firms back from investing in machinery to expand production lines.

Equipment buying figures to be flat this year, worse than previously expected. But sales should pick up come 2017 as the current headwinds die down.

REAL ESTATE A growing worry for the housing industry: The lack of real estate appraisers. As of last year, only 76,800 appraisers were working in the U.S...a 22% drop from 2007...and their ranks are set to keep dwindling. The majority of appraisers are over 50, and new certification rules discourage young folks from joining the field. Plus new financial regs steer more work to specialty appraisal firms, where pay is lower.

Fewer appraisers can mean trouble closing on a home in a timely fashion. Most residential mortgages require an appraisal to make sure that the purchase price doesn't exceed the value of the property. The shortage is already creating slowdowns for home buyers in rural areas, where the scarcity of appraisers is especially acute.

Federal regulators are looking harder at banks' commercial real estate loans because of concerns about looser underwriting standards amid an increase in lending. The investors who usually finance commercial loans by buying mortgage-backed bonds have been losing interest of late as they seek out investments that pay higher yields. Banks have filled the gap by financing shopping malls, apartment buildings, etc., and they could be exposed to very large losses if many of those projects end up failing.

Project owners could struggle to refinance loans if banks start backing away under federal pressure. Many property developers borrowed during the housing boom and will need to refinance this year or next. More of them will rely on shadow lenders... nonbank financial institutions whose lending isn't subject to strict bank regulations.

GLOBAL ECONOMY Yield-hungry investors are taking a fresh look at emerging markets, a switch from last year, when capital flows declined sharply. Near-zero interest rates in mature economies and signs of improvement in struggling nations such as Brazil are giving investors the confidence to open their wallets again. 2016 will see a doubling in capital going to emerging markets compared with 2015, hitting a solid $550 billion.

More investment in emerging markets is a good sign for the global economy, suggesting that investors haven't been spooked too badly by the Brexit vote in June. Mounting fund flows also could signal that investors don't expect China's slowdown to turn into a recession...a fear that roiled global financial markets earlier this year.

Great Britain's economic prospects are darkening quickly. Last month's vote to exit the European Union set off alarms about financial disruptions and job losses, fears that are starting to materialize now. A whopping 80% of British businesses plan to cut capital spending, and the British pound is trading near a 30-year low. Consumer confidence is plunging, and business sentiment is at its lowest since 2009.

A mild British recession later this year looks certain, despite new policies from the Bank of England that will likely be launched soon to mitigate the downturn. The U.K. economy will manage to eke out only 0.4% GDP growth next year. But Britain's woes won't derail global growth...the U.K. isn't big enough to do that.

POLITICS

Some dispassionate advice to folks on both sides of the presidential race: Don't read too much into results of any single question on election polls, even if findings seem to back your view. What you see isn't always what you get.

For example: Is the U.S. going in the right direction or on the wrong track? In polls, about 70% pick "wrong track" and 20% say "right direction," a decidedly sour view, but not surprising in the wake of the political conventions and the overall breakdown of political civility. But what do the numbers mean?

Republicans argue that the results are an indictment of President Obama, and by extension Hillary Clinton, putting Donald Trump in the driver's seat.

Democrats say the results reflect condemnation of the GOP-led Congress, which they blame for the partisan divide and the broad distrust of Washington.

In reality, the appalling numbers are driven by a blend of both views.

Otherwise, one candidate would have a lopsided advantage over the other. Instead, the polls showing leads for either candidate are within the error margin.

HEALTH CARE

Employers face earlier deadlines for reporting Obamacare info next year. The government will not extend them as it did this year, when employers had until March 31 to give workers the 1095 forms that are required by the IRS. The forms notify employees of their employer-provided health insurance coverage. The deadline for distributing 1095 forms for the 2016 tax year is Jan. 31, 2017. Paper 1094 forms, which describe the coverage to the IRS, must be filed by Feb. 28, while electronically filed 1094 forms must be reported to the agency by March 31.

A note to employers that get subsidy notices from federal health exchanges: The notice that an employee received a subsidy to help buy coverage on the exchange because the employer failed to provide required health insurance is just a heads-up.

No penalties are being assessed by the IRS...yet. Details about penalties won't be worked out until the end of the year, and once they're put into effect, employers will have the opportunity to respond, complete with an appeals process.

Of 4,599 hospitals surveyed, only 102 will be awarded five stars in new hospital quality ratings by the Centers for Medicare & Medicaid Services, an agency within the U.S. Dept. of Health and Human Services. An additional 934 will get four stars; 1,770, three stars; 723, two stars; and 133, one star. The ratings are based on more than 60 different criteria, such as how often a facility's patients get postsurgical infections and how long they wait in the ER prior to being seen. (The government didn't have enough data to score the remaining 937 hospitals.)

The ratings, due out soon, will be posted online on Medicare's website, giving prospective patients more information to consider when choosing a hospital.

Hospitals aren't happy with the ratings but won't be able to delay them based on their concerns that the grading is oversimplified and even misleading. Hospital advocacy groups, for example, contend that CMS didn't sufficiently adjust for those hospitals that treat the sickest patients and didn't give enough consideration to social determinants such as the racial makeup and income levels of folks they serve.

POT

America's aging population is increasingly turning to marijuana to ease the aches and pains that come with growing older. About two-thirds of the 2.7 million consumers of medical marijuana in the U.S. are 40 or older. The market for medical marijuana will continue to expand as more states legalize it, joining Washington, D.C., and the 25 states that already do so, and as the stigma of using it fades. Meanwhile, research on medical benefits of pot will be stepped up. For instance, medical pot might be able to displace highly addictive opioid painkillers.

RETAIL

Shoppers love free shipping. But retailers have come to loathe the practice. Consumers now expect the option, largely due to Amazon's adoption of it. The costly trend has merchants scrambling to avoid having to hike their prices.

Sellers plan to tweak their business models to offset rising delivery costs. Many retailers are considering Amazon's subscription model, which gives shoppers free two-day shipping for $99 per year. Walmart is testing a plan for half the price. Another idea: Offer special services upon delivery...installation, removal, etc...for a fee.

Consumers will pay a premium for faster delivery, even when free shipping is offered. Companies charging for express delivery can rake in much more revenue.

TRAVEL

Airfares are on the way down. Prices have already fallen in recent weeks by up to 8% and will slip further because of cheap fuel and weak demand. Look for special deals on Tues., Wed. and Sat., the slowest flying days of the week.

Expect more price cuts on some international routes later this summer. Terrorism and fear of the Zika virus have hurt travel to Europe and the Caribbean.

Deeper fare cuts are in store after Aug. 23, the unofficial end of summer. Figure on discounts of up to 15% domestically and as much as 20% internationally.

THE WORLD

Relations between the U.S. and Turkey will take a hit in the coming months as President Recep Tayyip Erdogan proceeds with his post-coup crackdown. Declaring a state of emergency, he has purged over 60,000 government employees.

Washington and Ankara will find it hard to work together after the failed coup. Erdogan's demand that the U.S. extradite a Turkish critic of his regime who lives in Pa. is a nonstarter. And the U.S. fears that his harsh repression could destabilize Turkey.

But the relationship is too important for either country to jeopardize. The NATO allies will continue to cooperate in the fight against the Islamic State, with American forces running bombing missions from Incirlik Air Base in Turkey.

Note some key European political events taking place in the next year or so:

The formation of a new Spanish government after close elections this June. Acting Prime Minister Mariano Rajoy will head a stable but weak coalition government.

Austria's presidential vote in Oct., the first major post-Brexit political test. The far-right party could call a referendum on European Union membership if it wins.

Italy's Oct. constitutional referendum, which could lead to the resignation of Prime Minister Matteo Renzi if voters reject it. That would trigger early elections.

France's spring 2017 election, which spells the end for François Hollande... the incumbent leader whose popularity is on the decline...leaving a wide-open field.

A Sept. 2017 election in Germany. Angela Merkel will likely stay in power. But a surging anti-immigrant party could force her to seek new coalition partners.

FOOD

Whoever the next president is, the U.S. will continue to fight global hunger. A recent bipartisan law signed by President Obama gives up to $1 billion in yearly farm aid to countries in Africa, Asia, Central America and the Caribbean. The goal is to help farmers in poor countries grow more crops and market them better.

It's more than charity. Food aid spurs economic growth and helps U.S. firms such as General Mills, Hershey and Cargill gain footholds and expand in new markets.

Yours very truly,

Knight Kiplinger

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